

Issue Paper Number 05-001



BOARD OF EQUALIZATION  
**KEY AGENCY ISSUE**

- ☐ Board Meeting
- ☐ Business Taxes Committee
- ☐ Customer Services and  
Administrative Efficiency  
Committee
- ☐ Legislative Committee
- ☒ Property Tax Committee
- ☐ Other

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## **PROPOSED PROPERTY TAX RULE FOR PETROLEUM REFINING PROPERTIES**

### **I. Issue**

Should the Board initiate the rulemaking process to adopt a Property Tax Rule that prescribes the valuation of properties used for refining petroleum?

### **II. Staff Recommendation**

Staff recommends that the Board initiate the rulemaking process and direct staff to begin the interested parties' process, using the attached proposed Property Tax Rule 474, *Petroleum Refining Properties*, as a starting point for discussions.

### **III. Other Alternative(s) Considered**

1. The Board could commence the official rulemaking process by approving publication of a Notice of Proposed Rulemaking Action for Proposed Rule 474 as submitted.
2. The Board could deny the request for rulemaking of a proposed Property Tax Rule that prescribes valuation of properties used for refining of petroleum.

## **IV. Background**

Under Government Code section 15606, subdivision (c), the Board is given the power and duty to prescribe rules and regulations to govern local boards of equalization and assessment appeals boards when equalizing and county assessors when assessing. The Honorable Claude Parrish, Chair of the Property Tax Committee, proposes that the Board, pursuant to its rulemaking authority, adopt a Property Tax Rule that prescribes valuation of real property, personal property, and fixtures used for the refining of petroleum.

Interested parties were advised of the proposed Property Tax Rule in Letter To Assessors 2005/008, dated January 14, 2005, and were invited to provide comments to staff in advance of the Property Tax Committee meeting scheduled for March 22, 2005. As of February 21, 2005, the Board staff has not received any comments from interested parties.

The Western States Petroleum Association reports that there are 20 major refineries located in California. Nine of the refineries are located in two counties: five are located in Los Angeles County and four in Contra Costa County. Los Angeles County and Contra Costa County data show the total assessed value of those refineries to be over \$14 billion with approximately 79% (\$11 billion) enrolled as fixtures. Projecting this information on a statewide basis indicates Rule 474 potentially affects the assessment of \$32 billion of refinery property of which \$25 billion consist of fixtures.

The issue at hand is whether the Board should adopt a rule for petroleum refining properties that would include a provision establishing a rebuttable presumption that, for purposes of recognizing declines in value, fixtures and machinery and equipment classified as improvements are within the same “appraisal unit” that contains structures and associated land. The statutory and regulatory framework for recognizing declines in value for property tax assessment is set forth in Revenue and Taxation Code section 51, subdivision (d), Property Tax Rule 461, which interprets that statute, and Property Tax Rules 468, 469, and 473, which provide for differing treatment of declines in value for specified types of property.

### ***Section 51 subsection (d)***

After the passage of Proposition 8 in November 1978, the Legislature enacted comprehensive Proposition 13/Proposition 8 implementation legislation (Assembly Bill 1488, effective July 10, 1979) consistent with the recommendations made in the *Report on the Implementation of Proposition 13* (Report). The Report, in relevant part, stated:

In determining the extent of a potential decline in value, the assessor must look to the net change in value of the appraisal unit which is commonly bought and sold in the market place, or which is normally valued separately...This means that land and improvements are ordinarily treated as a unit, and that a taxpayer cannot claim a net decline in full cash value terms of an improvement due to depreciation [i.e. decline in value], without also including any appreciation in the value of the land. If the building depreciation is offset by the increase in land value, then no reduction in assessment occurs. Fixtures however, are normally appraised separately, thus owners may claim a decline based on depreciation of the fixture without regard to the value of the surrounding land or improvements.<sup>1</sup>

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<sup>1</sup> *Implementation of Proposition 13*, Volume 1, *Property Tax Assessment*, Assembly Revenue and Taxation Committee, October 29, 1979, page 13.

In accordance with the Report's foregoing finding, section 51, subdivision (d) (formerly subdivision (c)) defines an "appraisal unit" alternatively as: (1) that which "persons in the marketplace commonly buy and sell as a unit" and (2) that which is "normally valued separately." The second alternative was adopted in recognition of the fact that fixtures and other machinery and equipment classified as improvements are normally valued separately.

***Rule 461 subsection (e)***

The Board adopted Rule 461, in June 1978 prior to the passage of Proposition 8 and enactment of section 51. The initial version of the rule addressed only declines in value caused by disaster but clearly allowed for base year value reductions when portions of real property are physically removed from an appraisal unit. Subsequently, on November 7, 1978, the voters approved Proposition 8, which addressed declines in value more generally.

After the passage of Proposition 8, the Board amended Rule 461 and implemented the Report's recommendation that fixtures and other machinery and equipment classified as improvements should be treated as a separate appraisal unit so that a decline in value would not be offset by value increases in land or improvements.

Some assessors commented at the time that such treatment would be an administrative burden because of the more rapid depreciation in the value of fixtures and other machinery and equipment classified as improvements as compared to structures. However, there was a general recognition of the need to apply Proposition 8 in a manner rationally related to the value of the components of a given property. Both the Executive and Standards Committees of the CAA approved the draft amendment to the rule. The Board adopted the language on January 25, 1979, and it has remained unchanged since that time.

***Rules 468, 469 and 473***

Rules 468, 469, and 473 prescribe the assessment procedures for oil and gas, mining, and geothermal properties, respectively. In contrast to Rule 461, subsection (c), each rule provides, as an exception to the general rule of decline in value appraisal, that fixtures and other machinery and equipment classified as improvements do not constitute a separate appraisal unit. In recognition of the unique nature of these properties, these rules were promulgated to address the specialized appraisal techniques required by Articles XIII and XIII A of the California Constitution. Rules 468 and 469 were adopted on June 29, 1978 and Rule 473 on June 29, 1995.

**V. Staff Recommendation**

Staff recommends that the Board direct staff to begin the interested parties' process, using the attached proposed Property Tax Rule 474, *Petroleum Refining Properties*, as a starting point for discussions.

**FORMAL ISSUE PAPER****A. Description of the Staff Recommendation**

Staff would initiate the interested parties process pursuant to the procedures contained in the *Property Tax Committee Procedures Manual* as follows:

- Develop an interested parties' mailing list
- Solicit comments and suggestions on the proposed rule language from interested parties
- Hold an interested parties meeting(s)
- Submit the final proposed rule language to the Board for consideration and adoption.

**B. Pros of the Staff Recommendation**

Initiating the interested parties' process will provide greater assurance for presentation of all views and thorough consideration of the issues prior to Board adoption of a rule. Adoption of a rule to prescribe assessment of properties used for refining of petroleum will promote uniformity and equitable assessments of these properties.

By directing staff to initiate the interested parties process, the Board will allow staff time to solicit input and build consensus between assessors and industry representatives. The interested parties' process will allow staff, along with assessors, industry, and other interested parties, to discuss other aspects of appraisal that should be addressed in a comprehensive rule for petroleum refining properties. These issues should include environmental concerns, the use of spot versus rack prices for inputs and products, estimating economic obsolescence, the treatment of new and replacement fixtures, and other valuation and assessment issues.

Additionally, the issue of fixtures constituting a separate appraisal unit for decline-in-value assessment was the subject of a recently-decided court case, *BP West Coast Products, LLC v. County of Los Angeles and City of Carson* Los Angeles County Superior Court (Case No. BC 269200) that has been appealed to the court of appeal. A decision was filed on May 26, 2004. The superior court held in favor of the taxpayer and remanded the case to the assessment appeals board to resolve valuation issues. Specifically, the court held that:

Rule 461(e) is consistent with Section 51 of the Revenue and Taxation Code, and it clearly requires the treatment of fixtures as a separate appraisal unit. Further the legislative history of Revenue and Taxation Code Section 51 confirms the policy implemented by Rule 461(e). Treatment of fixtures as a separate appraisal unit is consistent with the policy of Proposition 13....

The County of Los Angeles has filed notice of appeal and it is likely that the outcome of the case may decide the issue.

**C. Cons of the Staff Recommendation**

None

**D. Statutory or Regulatory Change**

Action by the Board will add section 474 to Title 18 of the California Code of Regulations, Subchapter 4.

**E. Administrative Impact**

None

**F. Fiscal Impact**

**1. Cost Impact**

Board staff routinely drafts proposed rules and any associated costs are accommodated within the Board's existing budget. There are no other costs.

**2. Revenue Impact**

None

**G. Taxpayer/Customer Impact**

None

**H. Critical Time Frames**

None

**VI. Alternative 1**

**A. Description of the Alternative**

The Board could approve publication of proposed Rule 474 as submitted. The proposed rule includes a rebuttable presumption that fixtures and other machinery and equipment classified as improvements are part of the larger appraisal unit. If an assessor rebuts the presumption then those properties would be assessed as a separate appraisal unit for declines in value.

**B. Pros of the Alternative**

Publication of proposed Rule 474 as submitted would allow the assessor to exercise discretion in determining whether fixtures and machinery and equipment classified as improvements are actually part of the larger appraisal unit.

**C. Cons of the Alternative**

Publication of proposed Rule 474 as submitted would allow assessors to assess petroleum refining fixtures as part of the larger appraisal unit, so that any declines in value of the fixtures component would be offset by the increased value of other components, such as land and structures. Industry believes that depreciation of fixtures and other machinery and equipment classified as improvements should be reflected as a reduction in taxable value that is not offset by the value appreciation of the land and structures.

**D. Statutory or Regulatory Change**

This alternative would require the Board to approve publication of section 474 of Title 18 of the California Code of Regulations, Subchapter 4.

**E. Administrative Impact**

None

## **F. Fiscal Impact**

### **1. Cost Impact**

The staff routinely drafts proposed rules and any associated costs are accommodated within the Board's existing budget. There are no other costs.

### **2. Revenue Impact**

Adoption of the CAA's petition would have an incremental revenue impact. See attached Revenue Estimate.

## **G. Taxpayer/Customer Impact**

The adoption of proposed Property Tax Rule 474 would limit reductions in the assessed values of fixtures as a result of declines in value because such declines in value could be offset by value increases in land and other improvements.

## **H. Critical Time Frames**

None

# **VII. Alternative 2**

## **A. Description of the Alternative**

The Board may deny the request for rulemaking of proposed Rule 474.

## **B. Pros of the Alternative**

By denying the request for rulemaking of proposed Rule 474, the Board would be recognizing that fixtures and other machinery and equipment classified as improvements of petroleum refining properties are subject to Rule 461(e) and should be treated as separate appraisal units for declines in value purposes. Arguably, this would confirm that Rule 461(e) has for 25 years achieved its purpose of providing assessment uniformity by ensuring that the same standard of valuation applies to all types of fixtures, except those fixtures specified in Rules 468, 469, and 473.

## **C. Cons of the Alternative**

Denying the request for rulemaking of proposed Rule 474 would, in the view of many assessors, fail to make a needed correction to the improper assessment of petroleum refinery fixtures and other machinery and equipment classified as improvements for decline-in-value purposes. Many assessors believe that treatment as a separate appraisal unit is inconsistent with proper appraisal practice based on the manner in which petroleum refinery properties trade in the marketplace.

## **D. Statutory or Regulatory Change**

None

**E. Administrative Impact**

None

**F. Fiscal Impact**

**1. Cost Impact**

The staff routinely drafts proposed rules and any associated costs are accommodated within the Board's existing budget. There are no other costs.

**2. Revenue Impact**

None

**G. Taxpayer/Customer Impact**

None

**H. Critical Time Frames**

None

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Current as of: March 2, 2005

**PROPOSED DRAFT LANGUAGE**

**RULE 474. PETROLEUM REFINING PROPERTIES.**

Authority Cited: Section 15606(c), Government Code  
Reference: Article XIII, Section 1, and Article XIII A, Section 2, California Constitution  
Sections 51, 53.5, and 110.1, Revenue and Taxation Code

**(a)** The provisions of this rule apply to the valuation of the real, personal property, and fixtures used for the refining of petroleum.

**(b) GENERAL.**

(1) The unique nature of property used for the refining of petroleum requires the application of specialized appraisal techniques designed to satisfy the requirements of article XIII, section 1, and article XIII A, section 2, of the California Constitution. To this end, petroleum refineries and other real and personal property associated therewith shall be valued pursuant to the principles and procedures set forth in this section.

(2) Notwithstanding any other provision in this section, any appropriate valuation method described in section 3 of title 18 of this code may be applied in the event of a transfer of an ownership interest in a petroleum refining property.

**(c) DEFINITIONS.** For the purposes of this section:

(1) "Petroleum refining property" means any industrial plant, including real and personal property, used for the refining of petroleum, as identified in Standard Industrial Classification (SIC) Systems Codes 2911 and 2992, or North American Industrial Classification System (NAICS) Codes 324110 and 324191.

(2) "Appraisal unit" consists of the real and personal property that persons in the marketplace commonly buy and sell as a unit.

**(d) DECLINES IN VALUE.** For the purposes of this section:

(1) Declines in value of petroleum refining properties will be determined by comparing the current lien date full value of the appraisal unit to the indexed base year full value of the same unit.

(2) The land, improvements, and fixtures and other machinery and equipment classified as improvements for a petroleum refining property are rebuttably presumed to constitute a single appraisal unit, except when measuring declines in value caused by disaster, in which case land shall constitute a separate unit.

(3) In rebutting this presumption, the assessor may consider evidence that:

(A) The land and improvements including fixtures and other machinery and equipment classified as improvements are not under common ownership or control and do not typically transfer in the marketplace as one economic unit.

(B) When the fixtures and other machinery and equipment classified as improvements are not functionally and physically integrated with the realty and do not operate together as one economic unit.



BOARD OF EQUALIZATION  
**REVENUE ESTIMATE****ISSUE # 05-001****PROPOSED PROPERTY TAX RULE FOR  
PETROLEUM REFINING PROPERTIES****Proposal**

Should the Board initiate the rulemaking process to adopt a Property Tax Rule pertaining to properties used for refining of petroleum?

**Staff Recommendation**

Staff recommends that the Board initiate the rulemaking process and direct staff to begin the interested parties process, using the proposed Property Tax Rule 474, Petroleum Refining Properties, as a starting point for discussions..

**Other Alternative(s) Considered**

1. The Board could direct staff to publish proposed Rule 474 as currently worded.
2. The Board could choose not to adopt a Property Tax Rule pertaining to properties used for refining of petroleum.

**Background, Methodology, and Assumptions**

The issue at hand is whether the Board should adopt for petroleum refining properties a rule that would create a rebuttable presumption that, for purposes of recognizing declines in value, fixtures and machinery and equipment classified as improvements are within the same "appraisal unit" that contains structures and associated land.

A new property tax rule pertaining to property used for the refining of petroleum was recently proposed. The proposed rule is Property Tax Rule 474 and is tentatively titled *Petroleum Refining Properties*. Under the proposed rule,

- (1) Declines in value of petroleum refining properties will be determined by comparing the current lien date full value of the appraisal unit to the indexed base year full value of the same unit.
- (2) The land, improvements, and fixtures and other machinery and equipment classified as improvements for a petroleum refining property are rebuttably presumed to constitute a single appraisal unit, except when measuring declines in value caused by disaster, in which case land shall constitute a separate unit.

Currently, fixtures are always a separate appraisal unit for the purpose of measuring declines in value under Rule 461. When fixtures are treated as a separate appraisal unit, a decline in their value, e.g., depreciation, may be independently recognized.

Under proposed Rule 474, fixtures may be considered part of a larger appraisal unit that also includes land and non-fixtures improvements. Under this treatment, a decline in the value of fixtures could be offset by an increase in the value of the associated land and improvements other than fixtures resulting in an assessed value that would be greater than or equal to the sum of the values produced under the current rules.

The revenue effect of not always treating fixtures as a separate appraisal unit for declines in value is extremely difficult to estimate due to the many factors involved and their lack of predictability. Among the factors are the following:

- 1) The amount of decrease in value of those fixtures that are not treated separately.
- 2) The amount of offsetting increase in value for the associated land and non-fixtures improvements.

The difference in assessed value for a property that is a candidate for the proposed treatment can be significant. This can be demonstrated as follows:

Property A is petroleum refining property that is purchased in year 0. Its real property assessed value in year 1 is \$1,000,000 for land; \$1,000,000 for improvements other than fixtures; and \$1,000,000 for fixtures. Suppose the market value of the land grows by \$100,000 a year for five years topping out at \$1,500,000 in the fifth year after the sale; that the fixtures remain in place and depreciate at a rate of \$100,000 a year; and that the market value of the other improvements remains unchanged. After five years, the market value of the property remains unchanged at \$3,000,000; however, the value is now allocated: \$1,500,000 for land; \$500,000 for fixtures; and \$1,000,000 for other improvements. Under the proposed rule, the assessed value in years 1 through 6 would remain constant at \$3,000,000.

When the fixtures are treated as a separate appraisal unit as in the current treatment, the assessed value of the property from years 1 through 6 is:

Year	Land & Other Imps AV	Fixtures AV	Total AV
1	\$2,000,000	\$1,000,000	\$3,000,000
2	\$2,040,000	\$900,000	\$2,940,000
3	\$2,080,800	\$800,000	\$2,880,800
4	\$2,122,416	\$700,000	\$2,822,416
5	\$2,164,864	\$600,000	\$2,764,864
6	\$2,208,162	\$500,000	\$2,708,162

In this example, the difference in assessed value between the two treatments grows from no difference in year 1 to nearly \$300,000 in year 6.

The Western States Petroleum Association reports that there are 20 major refineries located in California. Nearly half of the refineries are located in two counties: five are located in Los Angeles County and four in Contra Costa County. County data show the total assessment to be over \$14 billion with approximately 79% (\$11 billion) enrolled as fixtures. Projecting this

information on a statewide basis indicates Rule 474 potentially affects the assessment of \$32 billion of refinery property of which \$25 billion consist of fixtures.

Since the non-fixtures property value is relatively small when compared to the fixtures, any increases (short of the extreme) in their market value are easily absorbed by the depreciation in the fixtures. This means that under the proposed rule the property would be assessed at market value, except in the rare instance where the market value exceeds the Prop. 13 factored base year value.

For the 20 large petroleum refining properties in California that would be assessed by combining fixtures with other real property, the total difference in assessed value for the offsetting increase for land and structures is conservatively estimated to be: \$7 billion x 2%, or \$140 million.

## **Revenue Summary**

### **Staff Recommendation.**

There is no revenue impact in determining when to start the rulemaking process to adopt Rule 474.

### **Alternative 1.**

The total difference in assessed value under the proposed rule is estimated to be at least \$140 million. The difference in property tax from the basic 1 percent property tax rate is then \$1.4 million

The actual revenue effect could be considerably higher or lower depending on the number of properties that would be actually affected by this treatment and the actual amount of offsetting values.

### **Alternative 2.**

There is no revenue impact if the Board chooses not to adopt a Property Tax Rule pertaining to properties used for refining of petroleum.

## **Preparation**

This revenue estimate was prepared by Aileen Takaha Lee, Research and Statistics Section and reviewed by Mr. David E. Hayes, Manager, Research and Statistics Section. For additional information, please contact Aileen Takaha Lee at (916) 445-0840.

Current as of March 1, 2005